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INTERNATIONAL PROCUREMENT

NATO Allies' Implementation of Reciprocal Defense Agreements

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to summarize the results of our work on how various European NATO allies are implementing their reciprocal defense procurement memorandums of understanding (MOU) with the United States. This work culminated in a report we issued in March 1992.¹ In April 1991, I testified before this Subcommittee on certain aspects of the MOUs as part of a larger body of work we had done--also for this Subcommittee--on the potential impacts on U.S. defense trade resulting from various European political and economic initiatives.² At that time, I raised questions about the use of MOUs to enhance U.S. defense sales to the allies. On the basis of these questions, we further examined the workings of the MOUs, focusing primarily on European implementation of these agreements.

Today I will focus on (1) how the United States and the allies view and implement the MOUs, (2) whether MOUs provide opportunities for U.S. firms to compete freely and fairly in allied defense markets, (3) how allied governments' tariff practices affect contract selections, (4) allied contract-award grievance procedures, and (5) the Department of Defense's (DOD) efforts to monitor the MOUs. We visited or obtained information from eight European countries--Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain, and the United Kingdom--to address most of these matters.

Between 1975 and 1991, the United States signed reciprocal defense MOUs with 21 allied and friendly nations, including 13 European NATO members. The United States intends these agreements to enhance alliance-wide military readiness by promoting rationalization, standardization, and interoperability of military equipment. The MOUs also seek to promote competitive opportunities for the signatories' defense industries and to reduce certain barriers, such as buy-national laws and tariffs. When the earlier MOUs were signed, U.S. defense exports to the European NATO allies were significantly greater than U.S. defense imports from the allies. DOD estimated the trade ratio to favor the United States by about 8 to 1 in the late 1970s. However, due to many factors, this ratio has declined and since 1986 has leveled off to about 2 to 1 in favor of the United States.

¹International Procurement: NATO Allies' Implementation of Reciprocal Defense Agreements (GAO/NSIAD-92-126, Mar. 1992).

²European Initiatives and Reciprocal MOUs (GAO/T-NSIAD-91-30, Apr. 30, 1991) and European Initiatives: Implications for U.S. Defense Trade and Cooperation (GAO/NSIAD-91-167, Apr. 1991).

RESULTS IN BRIEF

The United States and its allies recognize that the MOUs are primarily national security agreements. However, several European government officials also emphasized the agreements' economic and trade aspects because the United States waives the Buy American Act to implement the MOUs. Since the allies do not have similar "umbrella" buy-national laws comparable to the Buy American Act, it is difficult to identify parallel actions taken by these countries.

MOUs do not ensure fair treatment for either U.S. or European firms. Even though the United States waives the Buy American Act, it places other restrictions on many of its defense procurements. The allies said that although they seek to maximize competition, they reserve the right to direct contracts to domestic or other European sources. As a result, access to defense markets on both sides of the Atlantic is a contentious issue.

Although some European governments pay tariffs on U.S. defense imports--and one country considers tariffs when evaluating U.S. companies' bids--U.S. government, U.S. industry, and allied officials did not consider tariffs to be a significant factor in contract selection. Also, while each country had some type of grievance procedure, contractors rarely file protests in Europe because this is not a customary business practice.

Although DOD seeks to improve access for U.S. contractors, it has not adequately followed up on some recent MOU-related initiatives. DOD should intensify its efforts to monitor specific aspects of MOU implementation and encourage the allies to designate government officials to assist U.S. contractors comparable to the way DOD offers assistance to European firms seeking business opportunities in the United States.

ALLIES RECOGNIZE ECONOMIC IMPORTANCE OF MOUS

European government officials we met expressed two central themes about the MOUs. First, they underscored the national security aspects of the agreements. Second, they also generally recognized their trade and economic value. The latter view stems from the fact that the United States waives the Buy American Act and import duties on eligible goods purchased with DOD-appropriated funds to implement the agreements. The Buy American Act, which dates back to 1933, established a policy preference for goods manufactured in the United States. As implemented, the act gives U.S. producers an advantage during contract evaluation by adding a cost differential to foreign products. DOD generally adds 50 percent to the offered price of foreign end products competing against a U.S. product.

Government officials from the United Kingdom, Germany, and France--the European allies with the largest defense exports to the United

States--consider the Buy American Act waiver an important benefit. British officials described the waiver as the "cornerstone" of the United States' implementation of the MOU. Officials from these three countries said that without the waiver, their defense contractors would be unable to compete with U.S. suppliers for DOD contracts. Netherlands and Spanish representatives told us that the MOUs may have had some effect in opening the U.S. defense market.

Since the allies do not have "umbrella" buy-national laws comparable to the Buy American Act, it is more difficult to demonstrate how they have implemented the MOUs. British and French officials told us that they have not been required to make any significant changes to their defense procurement systems as a result of the MOUs. Generally, the allies said their procurement systems are open and accessible, and they seek to maximize competition. British and German officials told us that the MOUs help keep their markets open to U.S. industry. British officials noted that from 1976 to 1989, the United Kingdom had purchased more than \$12 billion in defense goods from the United States.

MOUS DO NOT ENSURE COMPETITIVE OPPORTUNITIES FOR CONTRACTORS

The MOUs do not guarantee fair treatment for either U.S. or European defense firms. Although MOUs generally call for competitive contracting procedures, they also make clear that industry is responsible for finding business opportunities. The availability of these opportunities is a contentious issue within the alliance and NATO is currently examining barriers to defense trade and identifying ways to reduce them. Although the MOUs open up a portion of the U.S. defense market, U.S. statutory and regulatory restrictions--which the allies are keenly aware of--limit procurement opportunities for European contractors. For example, numerous laws prohibit DOD from procuring items such as specialty metals, anchor chains, machine tools, and various weapons and ordnance from foreign sources. Additionally, DOD must set aside some contracts for small and minority U.S. businesses and restrict procurements for national mobilization reasons. Despite these restrictions, DOD estimated that upwards of 44 percent of the U.S. defense procurement market--about \$56 billion--was open to foreign competition in fiscal year 1990.

On the other hand, European barriers on defense procurements are less visible. Allied officials told us that they seek to maximize competitive opportunities but reserve the right to limit competition or direct contracts to national or other European sources. A February 1991 DOD "white paper" outlined several European government practices that imposed barriers to defense trade and noted that the United Kingdom, France, and Germany all promote their national defense industries through either subsidies or sole-source contracts. Further, the French Ministry of Defense

routinely publicizes upcoming procurements but tends to select French contractors for serious negotiations. French officials told us that their defense market was second only to the United States in terms of being closed to foreign procurement.

Political and Economic Factors Can Influence Procurement Decisions

While the MOUs set forth the principles of fairness and market access, political and economic realities play an important role in procurement decisions. For example in June 1991, the British government selected a domestic firm to produce its new main battle tank over competing U.S., French, and German firms. During the competition, reports circulated in the United Kingdom that 10,000 domestic jobs would be lost if the contract was awarded to a foreign firm. Information we obtained suggested that the British candidate was not the first choice recommended by the British Army. We had detailed discussions about this case with British procurement officials. They said that in large procurements, political considerations must be taken into account by their government.

U.S. industry officials believe that successful marketing strategies should include opportunities for European defense firms to participate with U.S. firms. In fact, such participation is frequently tied to an offset arrangement required by many European countries.³ The degree of European industrial participation can be significant. For example, a U.S. firm teamed with a British firm in 1991 to win a \$2.6 billion prime contract to manage systems integration and provide other management support activities for the United Kingdom's next generation antisubmarine helicopter. Over 95 percent of the work, however, will be performed by British and Italian industry. An official from the U.S. firm said that potential political controversy was avoided by structuring the contract with significant European content.

NOT ALL ALLIES WAIVE TARIFFS ON U.S. DEFENSE IMPORTS BUT LITTLE IMPACT SEEN

The MOUs call for the reciprocal waiver of customs duties and tariffs as a means of reducing barriers to defense trade, consistent with national laws and practices. As I already stated, the United States waives the Buy American Act to evaluate bids and waives import duties on eligible defense goods. The allies' waiver of duties and tariffs depends upon how each government views its

³Offsets are a range of industrial and commercial compensation practices required by foreign governments and firms as conditions for the purchase of military exports. Offsets include technology transfers, licensed production, coproduction, and foreign subcontracting.

obligations to pay European Community (EC) tariffs on defense imports from non-EC countries. Some member states believe they are required to pay tariffs on such items; others reserve the right to waive or exempt such duties. Three countries in our review--Germany, the Netherlands, and Belgium--pay EC tariffs on defense imports from the United States. The United Kingdom paid duties on certain dual-use items.

More importantly, in our view, with the exception of Belgium, officials from these countries said that while they pay the EC tariffs, they do not consider them in bid evaluations. For example, German procurement regulations specifically exclude the cost of the tariff--about 3 percent--from bid evaluations.

Officials from these countries, including Belgium, told us that tariffs were not a determining factor in contract award selections. They said they were not aware of any cases where tariffs caused a U.S. firm's bid to be noncompetitive because other factors, such as quality, cost, and offsets were more important. U.S. government and U.S. industry officials that we talked to overwhelmingly agreed that tariffs were not a barrier to defense trade.

GRIEVANCE PROCEDURES

I would like to mention briefly the allies' procedures for protesting or grieving contracts. We were told that these procedures are rarely used by either U.S. or European contractors and that it is not considered a customary business practice in Europe to formally protest a contract award. In the United States various options are available to U.S. and foreign contractors wishing to appeal contract awards. For example, contractors can file protests with the agency that awarded the contract, the General Services Board of Contract Appeals (for automatic data processing contracts), and the GAO. In fiscal year 1990, GAO received over 2,800 protests.

U.S. industry representatives we met in Europe were generally unfamiliar with the allies' grievance procedures. Further, most officials said their companies would not file a protest for fear of ruining their chances of winning future contracts. However, we did find two recent cases where U.S. companies had publicly protested. In one instance, the German government reimbursed a U.S. firm for its bid costs.

DOD NEEDS TO INTENSIFY EFFORTS TO FOLLOW UP MOU INITIATIVES

DOD seeks, in a variety of ways, to improve market access for U.S. defense contractors doing business in Europe. However, we believe it should follow up on some recent MOU initiatives. For example, although MOU procurement procedures annexes have been signed with France, Germany, Italy, the Netherlands, and Norway in the last 2

years, DOD has not systematically monitored the extent to which all these countries are implementing them. The annexes are designed to promote more openness and accountability in European defense procurement and ensure equitable treatment for U.S. contractors. Increased monitoring is necessary because DOD has stated that the annexes are an important part of its strategy to increase opportunities for U.S. contractors in defense trade, including smaller U.S. firms. DOD officials acknowledged that they needed to do more follow up and told us that they intended to do so.

DOD also should do more to encourage the allies to identify "ombudsmen" within their own governments to assist U.S. contractors. In April 1991, DOD designated a senior-level official to serve in this capacity on behalf of foreign governments that have MOUs with the United States. The ombudsman is expected to assist foreign officials to comply with DOD acquisition regulations and investigate complaints of unfair treatment. I should point out that this position was established in response to a legislative requirement.

DOD encouraged the allies to designate a similar official, but only the Netherlands had officially done so among the European NATO allies at the time of our work. Several allied officials told us that U.S. contractors do not need an ombudsman because they already know whom to contact for assistance. While this may be true for larger, well-established U.S. firms, more small and mid-sized companies may be interested in competing in European markets for the first time and might benefit from an ombudsman.

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Mr. Chairman, Members of the Subcommittee, this concludes my prepared remarks. I would be happy to answer any questions you have at this time.

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